DIVISION OF BOND FINANCE
OF THE STATE BOARD OF ADMINISTRATION

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J. BEN WATKINS III
DIRECTOR

November 15, 2004

Mr. Keith Rake
Deputy Assistant Commissioner
Bureau of Public Debt
Department of the Treasury
P.O. Box 396
Parkersburg, West Virginia 26101-0396

RE: **Docket Number BPD-02-04**

Dear Mr. Rake:

This is in response to requests for comments on the Bureau of Public Debt's proposed amendments to 31 CFR Part 344 pertaining to State and Local Government Securities. As the agency of the State of Florida responsible for issuing the State's debt, we have been a frequent user of the State and Local Government Securities (SLGS) program since its inception. To date, the SLGS program has enabled the State to structure efficient refunding escrows with infrequent use of forward delivery contracts or other guaranteed investment contracts.

However, the proposed amendments to the SLGS program will add inflexibility and complication that will diminish the usefulness of the SLGS program to the Division. If the proposals are adopted in their current form, the State would be forced to more often consider using open market securities, forward delivery contracts and guaranteed investment contracts in our refunding escrows. Turning away from the SLGS program would not be our preferred option. Moreover if the proposed regulations cause us to abandon frequent use of the SLGS program, such result would run counter to one purpose of the SLGS program: to discourage issuers from investing yield restricted funds in open market securities. We believe that the usefulness of the SLGS program could be maintained if our concerns are addressed as outlined below.

1. Limitations on Marketable Security and SLGS Redemption Prior to Maturity

Proposed §344.2(f)(1)(ii) prohibits the purchase of a SLGS security with any amount received from the sale or redemption (at the option of the holder) before maturity of any marketable security, if the yield on such SLGS security exceeds the yield at which such marketable security is sold or redeemed. We ask that the BPD clarify the prohibition on redeeming marketable securities to purchase higher-yielding SLGS. It is a common practice in refundings for issuers to redeem prior to maturity marketable securities (usually federal obligations) in a sinking fund or debt service reserve fund securing refunded bonds and use those proceeds to purchase securities (often SLGS) in the refunding escrow. The liquidated securities represent gross proceeds of the refunded bonds that will be considered "excess" funds upon the issuance of refunding bonds. Current Treasury Regulations (the "Mixed Escrow Regulations") recognize this practice and permit such proceeds to be allocated to certain expenditures of the escrow. See Treas. Reg. §1.148-9(d)(2)(i) and (ii).

The proposed SLGS regulations would prevent this practice unless the excess proceeds of the debt service reserve fund were invested in SLGS yielding less than the redeemed marketable securities. The Division questions whether the practice described was intended to be prevented by the proposed SLGS regulations. The investment of sinking fund and debt service reserve fund moneys of the refunded bonds is governed by those bonds' authorizing documents (e.g. Issuer Resolution or Trust Indenture) to meet security and cash flow requirements; those funds are not invested with a view toward facilitating the acquisition of a cost-free option upon a subsequent refunding. Furthermore, the practice of liquidating excess sinking fund and debt service reserve fund investments for use in a refunding escrow is a common practice among issuers and one which is not described in any of the examples given (the example provided in §344.2(f)(2)(ii) and (iii) assume redemption of marketable securities in existing *escrows*, not marketable securities in debt service reserve funds of refunded bonds). If the proposed SLGS regulations were not intended to prevent the above scenario, then we would propose that an exception to §344.2(f)(ii) be included which would permit the redemption of marketable securities and subsequent investment of such proceeds in SLGS, regardless of yield, if the marketable securities were previously held in a sinking fund or debt service reserve fund of refunded bonds.

In addition to concerns about liquidating sinking fund and debt service reserve fund investments, we are also concerned with the overall premise of the proposed SLGS amendments as to redemption of marketable securities and SLGS, i.e. the prevention of restructuring SLGS escrows to eliminate negative arbitrage. The ability to engage in such restructurings serves the interest of the State and its citizens by permitting our office to generating greater levels of savings on the refunding, and under the current rules, such restructurings are permitted. While the permissibility of SLGS escrow restructurings may change, the obligation for our office to act in the best interest of the State will not. Accordingly, where market conditions are such that a particular refunding will generate substantial debt service savings, but will also generate negative arbitrage, it will be more likely for us to utilize escrow investments that give us the *possibility* of later restructuring to eliminate the negative arbitrage. If SLGS cannot be so restructured, then we will be forced to consider using open market investments, forward delivery contracts and guaranteed investment contracts for the refunding escrow. Although we support the federal government's efforts in reducing "yield burning" transactions (a goal that has been greatly advanced by the existence of a user-friendly SLGS program), we will not be able to afford to tangibly sacrifice the interests of the State by irrevocably committing to negative arbitrage in a refunding escrow. We, therefore, hope that whatever modifications are made to address the "free option" issue, those modifications take into consideration the reality that issuers must make cost-beneficial decisions, regardless of the policy merits of the more costly option.

2. Limitations on Cancellation

The proposed regulations provide that issuers can no longer cancel SLGS subscriptions without cause and cannot change the issue date of SLGS securities. While we understand the intent of these prohibitions is to improve the administration of the SLGS program by the BPD and prevent abusive practices, a prohibition on changes of issue dates and an effective prohibition on cancellation unnecessarily burdens issuers.

One of the most beneficial, if not the most beneficial, aspects of the current SLGS program is the ability to cancel a SLGS subscription if the transaction is no longer viable due to movement in prevailing rates or if all elements of the transaction cannot be put together in time. The usefulness of the SLGS program to the State without at least a reasonable cancellation policy would be greatly diminished. No one can know how prevailing rates will move at any point in time. The risk of committing to purchase a portfolio of SLGS when the viability of the refunding could change would likely be unacceptable, as would the cost of "riding out" the SLGS rates until the pricing of the refunding bonds. The more likely alternative would be to turn to open market securities, forward delivery contracts and guaranteed investment contracts, perhaps in conjunction with financial products, i.e. options and other derivatives, that mitigate or eliminate interest rate risk. The likely impact on the State would be a reduction in its participation in the SLGS program.

The same can be said for the prohibition on moving an issue date. Despite the best efforts of everyone, it is possible that a transaction cannot be closed on the date initially planned. Not taking this fact into account could prove to be just as risky to some issuers as the no-cancellation policy described above. Few issuers can afford to take delivery of SLGS securities when no refunding bonds have been issued to provide the purchase funds.

We propose that the current rule on cancellations and changing the issue date remain in place. However, if a limitation cancellations is adopted, then we would propose that at least a certain number of cancellations be permitted by issuers. The number of cancellations could be implemented on a deal-by-deal basis, e.g. one cancellation for each refunding transaction, or an issuer-by-issuer basis, e.g. "x" number of cancellations in a calendar year per issuer. Limiting the number of cancellations should address the BPD's administrative and anti-abuse concerns while still providing needed flexibility to issuers to cancel SLGS when a refunding moves "out of the money." Retaining the current rule on moving an issuance date merely maintains the status quo, which given the likely infrequency of legitimate users, should not impose an excessive burden on the BPD.

3. Limitation on Source of Funds for SLGS

The proposed SLGS regulations amend §344.0(a) to provide that SLGS securities may be purchased only from amounts that constitute gross proceeds of an issue. We question whether this now limits the ability of issuers to purchase SLGS securities from cash in order to accomplish a cash defeasance of bonds. If so, what are the policy reasons behind this limitation? Does this change mean that in order to purchase SLGS from equity proceeds, an issuer will be required to temporarily deposit the equity proceeds in the sinking fund of the bonds to be refunded, so that technically the funds will be considered gross proceeds of an issue? We request that the amendment be clarified to permit SLGS purchases from equity proceeds of the issuer.

In sum, as a government agency, we recognize that providing needed public services sometimes results in abusive practices by a few. However, we would urge the BPD to be mindful that that SLGS program was put in place to benefit issuers as well as help achieve certain policy objectives of the federal government. Because the federal arbitrage regulations permit issuers to structure refunding escrows to yield up to the arbitrage yield on refunding bonds, and because doing so serves the best interest of the State and its citizens, we will continue to structure escrows to minimize negative arbitrage. Where possible, we would prefer to use SLGS to achieve this objective. However, the proposed amendments to the SLGS regulations will doubtlessly cause us to consider other escrow funding options. We therefore request that the BPD soften its stance on at least the above items so that the SLGS program will continue to be a useful tool to the State and other non-abusive SLGS program participants in accomplishing sensible refunding transactions.

Sincerely,

J. Timothy Trinkley for

J. Ben Watkins III
Director

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